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Project Report

BRITISH COLUMBIA FINANCIAL REVIEW:

THE ISSUE OF ACCOUNTING POLICIES

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Executive Summary—Accounting Policies

This report is a comprehensive review of government accounting policies. Financial reporting plays a major role in fulfilling government's duty to be publicly accountable. British Columbia has traditionally been at the forefront of financial reporting and, in many respects, its accounting policies are still satisfactory. However, the report shows that the government has not fully kept pace with emerging professional accounting standards.

To provide the fullest disclosure and the most accurate overall picture of British Columbia's finances, the report makes the following recommendations:

- Consolidate all activities of government, including Crown agencies, into one principal set of financial statements, rather than the current practice of publishing three different sets of accounts. As part of this consolidation, adequately reflect the underlying value of investments in Crown corporations.

- Amend the Public Accounts to include on the balance sheet, previously unrecorded liabilities for:

    - unfunded pensions—$558 million.
    - unrecorded grants —$70 million.
    - contingent liabilities and commitments—$124 million.

- Reduce the value of concessionary loans on the balance sheets by $130 million.

- Separate capital and operating expenditures in the Estimates and Public Accounts.

- Consider including physical assets such as buildings, equipment and vehicles on the balance sheet while removing Fiscal Agency loans. Further study is required of other physical assets (roads, bridges and silviculture costs) before including these categories.

- Provide, in future financial statements, for the ongoing cost of pension benefits earned.

- Give better disclosure on commitments and "lurking expenditures".

When these changes have been implemented, the government will have responsibly discharged its objective of full and complete financial disclosure.

The Issue of Accounting Policies

A. Introduction and summary

As part of the Financial Review, we have completed a review of the Province's existing accounting policies to ensure they establish an appropriate framework for financial reports which provide for improved accountability and prudent fiscal management. Financial reporting plays a major role in fulfilling government's duty to be publicly accountable. We have used as a guide the statements and proposals of the Canadian Institute of Chartered Accountants (CICA) Public Sector Accounting and Auditing Committee (PSAAC). The development of consistent accounting standards for governments is relatively recent. PSAAC itself was established in 1981 with a view to proposing accounting standards for senior levels of government. Thus, where PSAAC is silent and has not yet made a pronouncement, we have used a considered and prudent application of relevant generally accepted accounting principles, as set out in the CICA Handbook.

The accounting policies reviewed in detail are:

- The appropriate government reporting entity.
- Accounting for pension plans and unfunded pension obligations.
- Accounting for government transfers.
- The valuation of low interest, concessionary loans.
- The valuation of fiscal agency loans.
- The treatment of physical assets.
- Contingent liabilities and commitments.

In addition, we reviewed the government's other existing accounting policies and determined that, where properly applied, they satisfied the requirements of the CICA as well as the requirements for prudent financial management. Indeed the Province of British Columbia has for many years been at the forefront of reporting as compared to other governments across Canada. For example, it was one of the first jurisdictions to adopt accrual accounting and one of the two provinces (Alberta was the other) which first produced a set of summary financial statements, consolidating the activities of its Crown corporations with other government accounts.

As a result of this review, we make a series of recommendations. These recommendations fall into two categories:

- Recommendations for immediate acceptance by the government for application to the current and future fiscal periods; because of the fundamental nature of some of these recommendations and their significance these would also be reflected in a restatement of prior annual financial statements.

- Recommendations for further study, which should be considered carefully by the government in its stated objective of providing an accurate picture of the province's financial position.

1. For immediate acceptance:

- The appropriate reporting entity for government is one which incorporates **all** activities of government, including Crown corporations and agencies. As a result, the government should:

  - prepare estimates of revenue and expenditure which incorporate the financial activities of Crown corporations and agencies which are essentially governmental in nature, as well as government ministries. This will have the effect of aligning the estimated results with the actual results reported in the Public Accounts.

  - report on a consolidated basis with the Consolidated Revenue Fund, including corporations and agencies which depend significantly on government financing or whose activities are governmental in nature. Those which are commercial in nature and primarily self-sustaining would be accounted for on a modified equity basis.

    In the implementation of this recommendation, the government's equity in Crown corporations should be reviewed to ensure the underlying values are properly reflected.

- Any legislation which may be affected by these recommendations (for example, the Financial Administration Act) should be reviewed and, if appropriate, amended.

- The government's obligations in respect of the unfunded liabilities in the Public Service Superannuation Fund and the British Columbia Public Service Long Term Disability Fund should be recognized and recorded in the Summary Financial Statements of the province. The government's possible moral responsibility in respect of funding the significant unfunded liabilities in the Teacher's Pensions and Municipal Superannuation Plans should also be noted in the Summary Financial Statements of the province. In addition, although the government is not

wholly responsible for funding these public service pension plans, their ongoing and cumulative underfunding needs to be addressed and resolved.

- Low interest, concessionary loans made by the government to outside parties should be written-off or, in some cases, written down to their present value, to reflect the fact that they really represent grants and should be accounted for as such.

- Government transfers of grants and contributions should be recognized in the period the events giving rise to the transfer occur and, in particular, when the relevant eligibility criteria are met.

- Obligations to incur expenditures relating to events or transactions that have occurred and which can be reasonably estimated are no longer contingent liabilities and should be accrued in the government's financial statements. In addition, such matters should be assessed on a portfolio as well as on an individual basis (e.g., the total portfolio of pending litigation against the government) and recorded at the lower end of a range of possible outcomes, since the loss is probable although the amount may be uncertain. This is similar to the approach currently used by the government in establishing valuation allowances on loan guarantees issued by the government.

- Further study should be undertaken of those contingencies which may require recognition as liabilities in the Public Accounts; these will include tax appeals, criminal injury claims, indemnities, site and environment clean-up costs, potential liability for environmental degradation, and other potential lawsuits for expropriation.

- The Public Accounts should disclose the nature, timing and amount of significant commitments. The amounts of legislative as compared to contractual commitments would be useful information.

- The changes to the accounting policies which we recommend should be effected on a retroactive basis because of their significant impact on the government's definition and presentation of financial assets and liabilities; such restatement provides greater consistency and comparability between fiscal years. Moreover, for the major items, PSAAC recommends retroactive restatement.

- The government should disclose proposed capital expenditures separately from operating expenditures in the annual Estimates. In addition, until physical assets are accounted for differently, these expenditures should be distinguished in the Public Accounts, so that the amounts expended on physical assets are more visible.

2. For further consideration:

- The appropriate accounting treatments for fiscal agency loans and physical assets are interconnected: further study should be undertaken to assess the extent of this interrelationship and the implications for the government reporting entity.

- Fiscal agency loans to government bodies which are recoverable from future government appropriations of funds, should be considered for write-down to reflect that they are not "true" financial assets of the province. As a minimum, the note disclosure on fiscal agency loans should be expanded.

- The government should move towards capitalizing physical assets. These would include highways, bridges, buildings, equipment and vehicles. Further significant study is required to:

    - identify and classify all physical assets in government
    - establish appropriate valuation and depreciation policies
    - determine a cost-effective means of assessing assets on hand and in use at the end of the fiscal year
    - establish appropriate systems for tracking asset acquisitions and disposals
    - separate consideration will need to be given to natural resources, including silviculture costs.

- As a first step, consideration should be given to recording those assets which are readily identifiable and for which values are available. These include: buildings, computers and other equipment and vehicles.

- Separate multi-year capital budgets should be prepared for all approved major capital projects.

B. The appropriate government reporting entity

The government produces a number of sets of financial statements within the Public Accounts, each of which is audited by the Auditor General, to reflect the various levels of activity under its authority. These activities are carried out through a variety of mechanisms and organizations: voted appropriations, special funds, statutory expenditures, Crown corporations and agencies. The three main sets of financial statements in the Public Accounts are:

- The General Fund.
- The Consolidated Revenue Fund, which includes the General Fund and any Special Funds (e.g., the Budget Stabilization Fund).
- The Summary Financial Statements, which include the Consolidated Revenue Fund and Crown corporations.

In addition, in order to improve accountability to the public, the government has separately published the financial statements of other individual funds and of all Crown corporations and agencies.

It has been argued that the financial affairs of the Province are too diverse and complex to be presented in one set of financial statements. The Consolidated Revenue Fund is the principal, legal funding conduit for the government's revenues and expenditures. It is the mechanism by which the Legislative Assembly authorizes government spending and receives monies due to the government. However, the General Fund financial statements have traditionally been used as the primary set of statements. There has frequently been confusion around which activities of government were, or were not, included in the General Fund statements (such as the debate which ensued around the Budget Stabilization Fund).

It is important that financial reports contain information which demonstrates the accountability of a government for its financial affairs and for the resources with which it has been entrusted. This necessitates that the government provide a full and complete accounting of those financial affairs and resources, including the activities of government corporations and agencies. This must be done within the context of clear, understandable and timely information. The taxpayers of British Columbia must be able to understand what government revenues and expenditures have been, what assets government has been entrusted with, the level and nature of its debt and other liabilities, and the ability to meet its obligations, and maintain the level and quality of services and programs.

As a minimum, therefore, it is our view that the General Fund financial statements should not continue with any degree of prominence—all actual and budgeted financial transactions should be reported in the Consolidated Revenue Fund financial statements. Indeed, there is little purpose served in reporting separately on the General Fund. Moreover, the need to provide increased accountability for all government activities supports the need for greater prominence for the activities of all Crown corporations and agencies, and as such, these should be included in the primary report by which government activities are measured and reported on. We also believe that it would be of greater benefit if the government Estimates were prepared on a similar basis, incorporating the proposed revenues and expenditures of the Consolidated Revenue Fund

with the operating budgets of the Crown corporations into one summary set of Estimates. We have recommended in the paper on Crown agency accountability that government-like organizations should be consolidated and government enterprises should be included in government reports (the Estimates and the Public Accounts) on a modified equity basis. It would then be possible for taxpayers to compare the actual results of **all** government activities with what was originally intended.

As described, such a proposal will require a change in the accounting treatment for Crown corporations and agencies in the financial statements of the Consolidated Revenue Fund. For example, it is our view that the activities of certain Crown corporations which are either akin to government programs (such as B.C. Buildings Corporation and B.C. Systems Corporation) or do not carry on a business and receive most of their funding from government (such as the B.C. Hazardous Waste Management Corporation) should be fully consolidated into the Consolidated Revenue Fund. This will have the effect of ensuring that the government's investments in Crown corporations and agencies are properly reflected in its primary set of financial statements. For example, although it is not currently reflected in the existing Consolidated Revenue fund financial statements and the forecast deficit on that Fund, we believe some adjustment to the government's carrying value of its investment in two Crown corporations, B.C. Rail Corporation and the Pacific National Exhibition, should be seriously considered. This concept is more fully developed in the issue paper on Crown agency accountability.

This proposal will probably necessitate legislative change to accommodate the activities of Crown corporations and agencies, as well as other funds within the Consolidated Revenue Fund. Currently, for example, the purpose of the Privatization Benefits Fund is to hold in perpetuity the net proceeds of assets disposed of through the privatization program. This purpose may prevent any commingling of these assets with other government assets.

In addition, PSAAC has recommended that all organizations which the government owns or controls and which are effectively accountable to a minister for their financial resources should be included in the government's reporting entity. If adopted, it would be necessary to incorporate education institutions and hospitals in the reporting entity. This would entail replacing items which currently appear as grants to these organizations by their assets and liabilities in the government's financial statements. The overall effect on the government's financial position is unlikely to be significant although we recommend that this change should be considered.

C. Accounting for pension funds

The provincial government maintains the Public Service Superannuation Fund ("the pension plan") to provide pension benefits to employees upon their retirement. The plan is a defined benefit pension plan open to eligible employees of the public service and certain crown corporations and other entities to which the Pension (Public Service) Act applies.

The government has a statutory obligation to provide the benefits promised by the plan. An actuarial valuation carried out as at March 31, 1990 showed that the plan had an

unfunded liability of approximately $438 million. A funding deficiency results when the actuarially determined liability to make future pension payments already earned by employees for services up to the current date exceeds the market value of pension fund assets. It should be noted here that, although there is a significant unfunded liability in this pension plan, it is relatively well funded compared with other provinces.

The government also maintains the British Columbia Public Service Long-Term Disability Fund ("the disability fund"), to provide for continuation of employees' income in the event of disablement. The pension plan and the disability fund cover essentially the same public service employee groups. An actuarial valuation of the disability fund at March 31, 1990 disclosed an unfunded liability of $34 million. The disability fund has the characteristics of a pension fund for accounting and disclosure purposes, in that it's obligations are benefits-based. For the remainder of this section, the discussion of the government's pension plans will encompass the disability fund.

Governments in Canada have traditionally recorded pension expense for a period equal to their cash contributions to a pension plan during the period. They have also disclosed any unfunded liabilities in the notes to their financial statements but have chosen not to record them as liabilities on their Balance Sheets. However, these liabilities are real. Pensions are a form of deferred compensation offered for services rendered and therefore, the costs accrue over the years in which employees render these services.

In 1988, following extensive study by PSAAC, the CICA issued Public Sector Accounting Statement number 5 ("PSAAC 5") which recommended that governments responsible for unfunded liabilities of pension plans record such liabilities on their own Balance Sheets with a corresponding increase in their accumulated deficiencies. Among numerous other related recommendations, the CICA also recommended that governments record pension expenses equal to the value of pension benefits earned by employees during the period rather than simply expensing cash contributions to pension plans. In addition, the CICA recommended disclosure of a great deal of pension plan information in the notes to financial statements.

1. Policies and practices of the B.C. government

In the recently released 1990/91 Public Accounts, the government continued its previous accounting policies and disclosures which do not follow the CICA recommendations. Among the deficiencies are:

- **The unfunded liability of the pension plan is not recorded on the balance sheet.** As a result, liabilities and the accumulated deficit of the government are both significantly understated. Also, the unfunded liability of the plan disclosed in the notes to the province's financial statements is the amount calculated for funding purposes only and is not calculated in accordance with PSAAC 5. The March 31, 1990 actuarial valuation, for which the unfunded liability of $438 million is disclosed, used a level contribution method of funding and the economic and demographic assumptions as determined by the actuary, whereas PSAAC 5 requires the use of the accrued benefit method of funding and

the economic and demographic assumptions of the plan sponsor, the provincial government.

A calculation by the actuary using the accrued benefit method of funding rather than the level contribution method showed that the unfunded liability would be approximately $441 million at March 31, 1990. While this result is not materially different from the $438 million unfunded liability calculated using the level contribution method, the methods are quite different and could result in significantly different results at a later date. To date, the province has not decided whether it will use the actuary's economic and demographic assumptions as its best estimate assumptions, or develop its own assumptions. If it decides to develop its own best estimate assumptions, a recalculation of the unfunded liability will be required to conform with PSAAC 5.

For the remainder of this section of the report, we will use the calculation which shows an unfunded liability of $441 million as the best estimate available of the unfunded liability for accounting purposes.

- **Pension expense consists of the year's capital contribution to the fund rather than the cost of pension benefits earned by employees during the year.** Current contributions to the fund have been a constant annual percentage of salaries and have not recognized the many ongoing market and experience factors that determine whether the amounts are appropriate to provide for pension benefits earned to date by employees. The calculation of pension expense for accounting purposes for 1990/91 would require the preparation of an extrapolation of the March 31, 1990 actuarial valuation to March 31, 1991 and a number of accounting calculations required by PSAAC 5.

  We estimate that the recommended imputation of interest on the unfunded liability, by itself, would result in an increase in 1990/91 pension expense of approximately $29 million, using a 6-1/2% interest rate. The accumulated deficit at March 31, 1991 would increase by a corresponding amount. Continuation of the old policy to date in 1991/92 is probably creating a similar understatement of the current year's pension expense and deficit.

- **The actuarial valuation of the pension plan does not reflect enhanced pensions.** We understand that judges, deputy ministers, the Ombudsman and the Auditor General are entitled to pension benefits that are 50% higher than other plan members. This enhancement is not reflected in the funding formula for the Public Service Superannuation Plan or in the actuarial valuation. Based on our discussions with pension officials, the understatements of the unfunded liability and current pension expense are approximately $8 million and $1 million annually.

- **Pension information in the notes to the government's combined financial statements lacks important disclosure recommended by PSAAC 5.** Such disclosure includes:

  - assumptions about long-term inflation rates
  - demographic information about plan participants
  - unamortized estimation adjustments and the periods of amortization

- **The unfunded liability of the British Columbia Public Service Long-Term Disability Fund is not recorded on the balance sheet nor is it disclosed in the notes to the financial statements.** As a result, liabilities and the accumulated deficit of the government are both understated by approximately $34 million. Disability fund expense consists of the government's cash contributions during the year, rather than the value of benefits expected to be paid to employees.

  As in the case of the pension plan, the actuarial valuation was not carried out using the accrual accounting principles set out in PSAAC 5. The unfunded liability and current year expense for accounting purposes are not known. For the remainder of this section of the report, we will use $34 million as the best estimate available of the true unfunded liability as at March 31, 1991 and $2 million (interest imputed on the unfunded liability at 6-1/2%) as the amount of understatement of the current year's deficit.

2. Other senior government jurisdictions in Canada

The pension accounting policies followed by senior governments across Canada are beginning to follow PSAAC recommendations. We understand that the Government of Canada and the Province of Quebec include unfunded pension obligations in their financial statements. In addition, the provincial auditors in Manitoba, Saskatchewan and New Brunswick have qualified their most recent opinions with respect to the failure of their governments to record unfunded pension obligations in their financial statements.

3. Support for adopting CICA recommendations

The reports by the Auditor General on the province's Public Accounts for each of the four fiscal years ended March 31, 1990 urged the government to adopt the CICA recommendations so that the Public Accounts would recognize the significant pension liability that exists and also record pension expense which corresponds to the value of pension benefits earned by employees in a period. Following the lack of response to these urgings, the Auditor General issued a qualified opinion on the

government's 1990/91 Public Accounts, apparently the first qualified report in the history of the province.

Adoption of the CICA recommendations also has the support of the most senior financial officials in the Ministry of Finance & Corporate Relations who recommended recording the government's unfunded pension liability in the 1990/91 Public Accounts. In addition, the Superannuation Commissioner concurs in principle with the Auditor General's recommendation.

4. Other pension plans

In addition to the Public Service Superannuation Fund addressed above, which is funded directly by the government and most Crown corporations and agencies, a number of other pension funds are maintained for employees of certain Crown Corporations, for other public sector employees in entities which receive significant provincial government funding and for members of the Legislative Assembly.

The principal separate pension funds for Crown Corporations are the British Columbia Hydro and Power Authority Pension Fund and the B.C. Rail Ltd. Pension Fund. Financial statements of these funds are published in the Public Accounts. Both of these funds had funding surpluses at their most recent actuarial valuations and both corporations are accounting for their relationship with these funds in accordance with generally accepted accounting principles. They will not be dealt with further in this section.

The accounts and funds maintained to provide pension benefits to other public sector employees in entities which receive significant provincial government funding are shown in Exhibit 1.

Under existing legislation, the provincial government has statutory responsibility for any funding deficiency of the College Pension Fund equal to the amount specified by the Lieutenant Governor-in-Council. This contingency is disclosed in a note to the government's Summary Financial Statements and the financial statements of the fund are published in the Public Accounts. There is no statutory responsibility for the government to cover the funding deficiencies of the Municipal Superannuation Fund or the Teachers' Pensions Fund. There is no mention of these plans or their unfunded liabilities in the notes to the government's Summary Financial Statements, although the financial statements and results of actuarial valuations of both are published in the Public Accounts.

Exhibit 1
Assets and unfunded liabilities of other public sector pension funds

	Group Covered	Total Assets At Latest Year End (millions)	Latest Actuarial Valuation: Unfunded Liabilities (millions)	Latest Actuarial Valuation: Date
College Pension Fund	B.C. college faculty and some administrators	$ 283	$30	Aug. 31,1988
Municipal Superannuation Fund	Employees of a B.C. municipality, hospital, school district, regional college, etc.	$4,230	$1,082	Dec. 31,1988
Teachers' Pensions Fund	Teachers and Superintendents in the B.C. Public School System	$3,223	$1,605	Dec. 31, 1987
		$7,736	$2,717	

* *Based on "level contribution" method of funding and the actuary's economic and demographic assumption rather than use of the "accrued benefit" method and the sponsor's economic and demographic assumption, as recommended by the CICA. Actuarial valuations have not been prepared for these plans using the CICA recommendations.*

The question arises, however, as to where the money will come from to ultimately pay the pensions of individuals covered by these plans. The following facts are relevant:

- The provincial government is a major source of revenue for all of the principal employers of individuals covered by these plans. In some cases, the province provides virtually all of the funding. For example, school districts which employ the teachers had a $1.6 billion unfunded liability at December 31, 1987. Also, approximately 65% of the employees covered by the Municipal Superannuation Fund, which had an unfunded liability of $1.1 billion at December 31, 1988, work in health care and educational and other facilities which are funded virtually 100% by the province. The remaining 35% of the members of the plan are employees of municipalities and regional districts which also receive some funding from the province. Likewise, the employers of members of the College Pension Fund receive some funding from the province.

- The pension funds and accounts are administered by the provincial government Superannuation Commissioner, who is also the plan trustee. Contribution and investment policy is controlled at the provincial government level, and the financial statements of the funds and accounts are published in the province's annual Public Accounts.

- The consulting actuary for the Teachers', Municipal and College plans has called for increased statutory contributions to at least a level to prevent further increases in the unfunded liability relative to payroll. Any increase in the employers contribution would have a direct impact on provincial finances and, to date, the contribution rates have not been increased. As a result, unfunded liabilities are generally increasing and costs, which the provincial government may ultimately face with respect to pension benefits already earned by plan members, are not being recognized in the provincial government financial statements.

- Based on the financial statements of the Teachers', Municipal and College plans, and our discussions with pension officials, it appears that the portion of the annual underfunding of these plans attributable to the provincial government amounts to approximately $37 million for 1991/92. This is based on an estimated current underfunding of the Teachers' and Municipal plans by approximately 1.1% of salaries of plan members and 2.14% for the College plan.

We recognize that some of the employers of members of these plans have sources of revenue other than from the province and that at least a portion of the unfunded liabilities can be paid from these sources. Also, increased employee contributions or improved investment returns by means such as asset diversification could reduce the unfunded liability in the future. Even in the case of the public school system, other funding sources such as separate taxation could be possible in the future. Moreover, we recognize that underfunding is a problem to be addressed by both employers and employees. However, notwithstanding these other existing and potential sources of funding, it seems possible that the provincial government will ultimately decide to pay a substantial portion of the unfunded liability relating to employees of entities which are funded wholly or in part by the provincial government. It appears, therefore, that many of the same principles that lead to the need to record, in the Public Accounts, the unfunded liability of the Public Service Superannuation Fund could equally apply to the recording of a substantial portion of the unfunded liability of the Teachers' Pensions Fund and a significant amount of the unfunded liability of the Municipal Superannuation Fund and College Pension Fund.

The financial statements of the Members of the Legislative Assembly Superannuation Account ("MLA plan") are also published in the Public Accounts. An actuarial valuation of this fund, which is a statutory funding responsibility of the Province, is not required by law and has not been performed to date. At March 31, 1991, assets of the MLA plan amounted to $3.4 million .

It is clear from our discussion with the Superannuation Commissioner that annual contributions to the MLA plan are significantly lower than the cost of pension benefits earned. As evidence of this, after each election, an amount is paid into the Public Service Superannuation Fund, through current appropriations, to cover the cost of pensions of former members of the Legislative Assembly who qualify for pension entitlements (seven years of service or elected three times). The amount to be charged against fiscal 1992 expenditures with respect to pensions for qualifying members retiring from the Legislative Assembly in 1991 is in the range of $5 million to $8 million. All of this relates to service to the government in 1990/91 or prior. It appears that the annual underfunding of this plan is in the order of $1 million to $2 million.

5. Conclusions and recommendations

We are concerned not only with the government's accounting for pension plans, but also with the underfunding of public sector plans which has resulted in an aggregate unfunded liability of over $3 billion. This liability will likely increase in January, 1993, when the new B.C. Pension Benefits Standards Act reduces the vesting period from ten years to five and further in 1998, when the vesting period reduces to two years. The need for increased funding of public sector pension plans must be addressed.

At present, there are serious deficiencies in how the government deals with pension plans in its financial statements. The CICA recommendations in PSAAC 5 on accounting for pension plans by public sector entities represent the collective view of leading public sector accountants across Canada. They are also consistent with the provincial government's stated basis of accounting, the accrual basis, which requires that all liabilities be recorded to the extent that they represent claims payable to outside parties as a result of events and transactions prior to the year-end.

We recommend therefore, that the recommendations of PSAAC 5 be implemented in the financial statements of the province. Essential elements of accounting for the government's relationship with the Public Service Superannuation Fund and the British Columbia Public Service Long-Term Disability Fund include:

- Requesting from the actuary, an extrapolation to March 31, 1992 of March 31, 1990 actuarial reports prepared in accordance with PSAAC recommendations, including use of the accrued benefit method of funding rather than the level contribution method, and economic and demographic assumptions of the provincial government.

- Calculations of pension plan and disability fund expense on the accrual basis of accounting, as set out in PSAAC 5, including calculation of interest on the unfunded liability.

- Recording of the unfunded liability in the province's financial statements on a retroactive basis as called for by PSAAC—if 1990/91

expense calculated on the PSAAC method differs materially from the expense now recorded in the 1990/91 financial statements, this would involve re-statement of the Statement of Revenue and Expenditure for 1990/91.

- Disclosure in the notes to the financial statements of all required pension plan information.

In addition, the province should consider ways to recognize in its accounts the reality of its involvement with the Teachers', Municipal and College plans. Although the province has no **statutory** obligation to cover the unfunded liabilities of the Teachers' and Municipal plans, the substance is that the current funding structure for the related employers puts most of the burden on the province. Also, the province's statutory obligation to cover the College fund unfunded liability is subject only to Lieutenant Governor-in-Council approval.

There is a case to support treating the Teachers' plan and a significant portion of the Municipal and College plans as direct obligations of the province and accounting for them in the same way as recommended above for the Public Service Superannuation Plan. This is, however, the responsibility of both the employers and the employees. **As a minimum**, we recommend that:

- The unfunded liabilities of these plans, calculated in accordance with PSAAC 5, be disclosed in the notes to the Summary Financial Statements of the province.

- The annual funding for the plans be carefully reviewed and a funding structure adopted which will recognize the cost for accounting purposes of pension benefits earned on an ongoing basis and eliminate the unfunded liability of the plans over an appropriate period. If this is implemented immediately, the additional expense for 1991/92 will be approximately $37 million, **just to prevent the unfunded liabilities from increasing, relative to payroll.**

With respect to the MLA plan, we recommend that the funding contribution be reviewed and increased to an appropriate amount to cover the estimated pension cost related to services rendered. It may also be useful to carry out an actuarial valuation, say every five to seven years, to ensure that contributions to the account are adequate to cover benefits earned and that appropriate recognition is given in the government's financial statements.

Because current actuarial valuations and extrapolations have not been prepared for any of the plans in question using all of the recommendations of the CICA, it is not possible to conclude definitely on the adjustments required in the government's financial statements with respect to pensions. However, using the information that is available, Exhibit II is our best estimate of adjustments which should be recorded

to more correctly reflect the true cost of pensions in the province's financial statements.

Exhibit II
Effect of accounting policy changes on accumulated deficit

	($millions) Increase in Deficit	
	Fiscal 1991/92	Prior Years
Record unfunded liability of Public Service Superannuation Fund		
Based on actuarial valuation	$29	$441
Enhanced pensions	1	8
	$30	$449
Record unfunded liability of B.C. Public Service Long-Term Disability Fund	2	34
Accrue additional funding for MLA plan	2	4
Total	$ 34	$ 487

In addition, we believe that the Public Accounts should, as a minimum, reflect a level of contribution to the Teachers', Municipal and College plans which as recommended by the consulting actuaries would prevent the unfunded liabilities from increasing beyond their current levels as a percentage of payroll. This would result in an addition of $37 million to the current year's deficit.

D. Concessionary loans

A number of ministries administer loan programs that make advances that have substantial concessionary terms. These concessionary terms typically take the form of low interest and/or very long repayment terms.

In our review of the government's portfolio of loans, two categories of loans and investments were identified:

- Loans made under terms which are so concessionary that the substance of the transaction is more in the nature of a grant.
- Loans made under terms that would likely result in the advances being repaid within a reasonable time and with adequate security backing the advance.

Any concessionary aspect therefore relates mainly to the difference between a commercial lending rate and the rate charged by the province.

We propose that new accounting policies be adopted to take into account the different concessionary nature of these two categories of loans. In respect to the first category of loans, we believe that the terms under which these advances are made are often so concessionary that the substance of the transaction is more in the nature of a grant and, therefore, they should be accounted for as a grant.

In respect to the second category, we believe that there is justification to assume that the advances will be repaid. We therefore believe that the appropriate accounting treatment would be to record as an asset the present value of the amount expected to be repaid. The present value would be calculated by applying a market interest rate as a discount factor and calculating the present value taking into account the expected date of repayment. The difference between the amount advanced and the present value of the amount expected to be repaid would then be recognized as an expenditure in the year the advance is made.

The impact of this proposal, if accepted, on the government's financial position would be significant: the total estimated carrying value of concessionary loans at March 31, 1991 exceeded $110 million. Such loans include loans made under the Canada/British Columbia Economic and Regional Development Agreement ("ERDA"), various ad hoc loans, venture capital loans advanced by the Discovery Foundation, and advances made to the company building the Vancouver Island Gas Pipeline. These are discussed in greater detail in the issues paper on Loans, Investments, Accounts Receivable and Guarantees.

Our proposed accounting treatment is an attempt to recognize that, with low interest rates and long repayment terms, some loans cannot be considered to have significant value as financial assets.

Adopting this accounting policy would make a significant adjustment to the accumulated deficit, as many loans recorded in the Public Accounts are attributable to prior years. If concessionary loans are accounted for as grants as we recommend, with some projects having a future residual value and the balance having none, an adjustment in the order of $79 million would be made to prior periods.

Similarly, the current year's deficit would be increased by $11 million if this accounting policy was adopted. There are, for example, significant loans to be made by the Ministry of Energy Mines and Petroleum Resources in respect of the natural gas pipeline to Vancouver Island. It is estimated that loans of $18.4 million, relating to the pipeline, will be made in the year ending March 31, 1992.

In addition, the student loan program provides similar concessions under the remission policy. This is described in greater detail in the issue paper on Loans, Investments, Accounts Receivables and Guarantees. We estimate that application of the concessionary loans accounting policy to this program would necessitate an adjustment in the order of $30 million to prior periods and up to $10 million would be added to the current year's deficit.

In our view, this accounting treatment is appropriate to all of these types of concessionary loans which are made by the government and we recommend that the proposed changes in accounting policy be adopted.

E. Accounting for government transfers

Government transfers are transfers of money from the government to individuals or organizations, where government does not receive goods or services in return or expect repayment or a return in the future. They represent a significant portion of the province's revenues and expenditures. Currently, close to 15% of provincial revenues are federal transfers and over 75% of provincial expenditures are incurred by way of expenditures as grants and contributions. Grants include expenditures to third parties which have been made in accordance with established eligibility criteria, but where there are no contractual requirements (such as grants to municipalities or income assistance payments). Contributions, on the other hand, include expenditure payments made under an agreement, contract or statute, to public bodies and organizations for the provision of goods and services to the public, where the government has control over how the funds are to be spent (such as payments to hospitals and school districts).

The government's current policy is to record expenditures or grants when disbursement of the funds has been authorized and contributions at the earlier of the date when payment has been authorized and the date when stipulated performance conditions are achieved by the recipient. Federal transfers are recorded as revenues when the payments are received.

In 1990, PSAAC issued a statement "Accounting for Government Transfers" (PSAAC 7) which sets out recognition criteria as follows:

> *Government transfers should be recognized in a government's financial statements as expenditures or revenues in the period that the events giving rise to the transfer occurred, as long as:*
>
> - *the transfer is authorized;*
> - *eligibility criteria, if any, have been met by the recipient; and*
> - *a reasonable estimate of the amount can be made.*

This recommendation has the potential effect of moving forward the date at which grants and contributions are recognized in the accounts. The Office of the Comptroller General has indicated that it supports adoption of the recommendations in this Statement, but is still collecting information on the relevant classifications of government transfer.

We recommend immediate adoption of PSAAC 7 and would note the following implications for the Public Accounts:

- ➤ Federal transfer revenues are not likely to be affected in the short-term since they are still unable to be reasonably estimated; however, additional work

should quickly be undertaken to assess whether better estimates can be obtained, especially with the federal government placing greater emphasis on attempting to estimate amounts payable to the provinces.

- Grants which have been authorized and whose eligibility criteria have been met, but which have not yet been approved for payment, will need to be accrued as an expenditure at that point.

- In addition, some grossing-up of revenues and expenditures for contributions received from the federal and other governments will take place for disclosure purposes, but this will not affect the government's financial position.

F. Fiscal Agency Loan Program

The fiscal agency loan program was instituted to give universities, school and hospitals (USH) access to the province's preferred rate of borrowing to obtain loans for the acquisition of physical assets. Prior to the Fiscal Agency Loan Program, each group borrowed on its own, usually with a government guarantee. The debts did not show on the province's balance sheet but the guarantees were shown as a contingent liability. The program also includes borrowings on behalf of certain government organizations and enterprises.

Fiscal agency loans made to government corporations and agencies that are financially viable and do not depend on government funding for operations clearly have value and represent valid assets of the government. However, there has been considerable discussion as to the appropriateness of carrying as an asset loans made to entities which will require government appropriation in order to make interest and principal payments.

1. Policies and practices of the B.C. government

The current accounting treatment in the government's Summary Financial Statements carries as an asset the full amount of loans receivable from provincial government-owned organizations which are not consolidated (i.e., carried on the modified equity basis), and loans receivable, either directly or through provincial financing authorities, from school districts, hospital districts, municipal borrowers and universities and colleges. At March 31, 1991, the total of such loans receivable carried on the Summary balance sheet was $7,396 million. Our recommendation for including government-owned corporations and agencies within the Consolidated Revenue Fund accounting entity would result in the CRF containing the same fiscal agency loans receivable as now are shown in the Summary Financial Statements.

At March 31, 1991, the Summary Financial Statements showed fiscal agency loans receivable as set out in Exhibit III:

Exhibit III
Fiscal agency loans receivable

	($ millions)
Government Owned Corporations	
B.C. Hydro and Power Authority	$3,736
B.C. Transit	979
B.C. Railway Company	78
B.C. Assessment Authority	6
	$4,799
School Districts	954
Regional Hospital District	852
Post-Secondary Educational Institutions	530
Municipal Entities	261
	$7,396

Prior to the Fiscal Agency Loan Program, these loans receivable and the offsetting loans payable would not have been recorded on the government's balance sheet. The loans would have been incurred by the individual organizations and recorded as liabilities on their balance sheets. The government's guarantees would have been disclosed as contingent liabilities in the notes to its financial statements.

2. Other senior government jurisdictions in Canada

In his report on the 1990/1991 Public Accounts, the Auditor General detailed the treatment of fiscal agency loans by other provinces. It is clear that there is a strong trend on the part of provincial governments, supported by provincial auditors, to treat loans which can only be serviced by the borrowing entity through receipt of government appropriations as expenses of the government at the time the loan is made. Ontario, Alberta and New Brunswick now follow this, or a similar, policy and the Provincial Auditor in Saskatchewan has qualified his report because of this issue.

3. Analysis

The issue of fiscal agency loans is very important and undergoing a great deal of current debate. It is likely that the Auditor General, supported by PSAAC, will continue to recommend reduction in the carrying value of these loans. One

possibility is that if PSAAC issues a statement of recommendations on the treatment of these loans, the Auditor General could express a formal reservation, or qualification, in a future report on the government's financial statements.

In addition, there is some inconsistency in the existing treatment of fiscal agency loans, in that the government, in its Summary Financial Statements, writes off grants to health facilities of $70 million which are similar to fiscal agency loans.

By recording those loans repayable through future appropriation as grants, the government would make expenditures on social capital more visible to the taxpayer—capital spending for schools, hospitals and universities has increased sixfold since 1987.

As described earlier, the fiscal agency loans are not represented by financial assets. By describing them as such, the government has disclosed the financial position in a more favourable light than would otherwise have been the case. If this change had been made in prior years it would have had the effect of significantly increasing the cumulative deficiency of the Province; the amount the Province disclosed as debt used for the fiscal agency loan program would not have been represented by offsetting assets. It would also have separately disclosed an increase in the cost of debt service in 1991/92 and prior years.

We therefore believe that consideration should be given to writing down the value of those fiscal agency loans which are repayable from future appropriations. We recognize, however, that this is very much interconnected with the issue of the appropriate accounting for physical assets and that each of these major areas should be studied together in further detail. As a minimum, we recommend that additional disclosure be provided in the notes to the government's financial statements to make it clear that certain fiscal agency loans are only recoverable from future government appropriations.

G. The accounting treatment of physical assets

Physical assets for purposes of this report include highways, bridges, ferries, buildings (including schools, hospitals and universities), equipment, vehicles and Crown Land including parks and forests.

The government of British Columbia annually spends a significant amount of money on new physical assets: ministries alone are estimated to spend in excess of $500 million; the amount spent by Crown corporations is of a similar magnitude; and there is no easy way of determining the proportion of the $12 billion in grants and contributions—primarily in the health and education sectors—spent on physical assets. Physical assets are recorded as expenditures in the Public Accounts and there is limited disclosure of physical assets on hand in these financial statements.

Generally, physical assets are capitalized on individual Crown corporations' and other government enterprises' financial statements. The financial statements of certain of the

government-styled, financially independent corporations and enterprises are adjusted to government accounting policies which include the write-off of fixed assets, and then consolidated in the Summary Financial Statements. For the remaining corporations and enterprises, the equity of the enterprise rather than its physical assets are shown on the Province's summary financial statements. Similarly, while physical assets are capitalized on the books of school boards, hospitals, universities, etc., these physical assets are not disclosed in the financial statements of the province. Further, apart from the provincial transportation system, the Province does not disclose the capital (versus operating) expenditure component in its annual estimates.

1. Policies and practices of the B.C. Government

The Auditor General points out in his recent report that, in his opinion, the government's Summary Financial Statements for 1990/91 comply with all but ten of the recommendations of PSAAC Statement 3 issued in 1986. One of these ten is as follows:

> "Financial statements should disclose information to describe a government's acquired physical assets on hand and available for use by the government at the end of an accounting period."

Another related recommendation, which is only partially followed, is that "financial statements should disclose information to describe a government's material financial commitments at the end of the accounting period". The Auditor General goes on to comment that "material financial commitments are not well defined and, for those circumstances where physical asset acquisitions involve large undertakings, the estimated total multi-year project costs are not provided".

2. Other senior government jurisdictions in Canada

- **Estimates presentation:**

  - The definition of capital varies within Canada. Many jurisdictions include debt service contributions and other grants for capital purposes, in addition to the acquisition of physical assets, in the definition of capital budgets.

  - With the exception of New Brunswick's capitalized "Vehicles and Heavy Equipment", the cost of physical assets and other capital outlays that have economic or service potential extending to future periods are treated as a component of the expenditure budget in the year of acquisition.

  - Unlike British Columbia, most other jurisdictions in Canada present capital outlay, including the acquisition or construction of physical assets, separately in the expenditure estimates.

- Spending authority for all voted expenditure lapses annually, with the exception of the estimates for capital expenditure in the province of Nova Scotia. These budgets operate on a bi-annual basis.

► **Significant accounting policies**

- The common stated accounting policy for physical assets by the federal and all provincial and territorial governments results in disbursements for fixed assets being recorded as expenditures. Slight differences in the wording of accounting policies indicates that capital expenditures are charged to equity separately from net operating results in the four Atlantic provinces.

- In ten jurisdictions, including British Columbia, the acquisition of physical assets is recorded in the year of acquisition. In three other jurisdictions physical asset expenditures are recorded in the year of payment.

► **Financial statement presentation**

- Although all Canadian jurisdictions, except New Brunswick, charge fixed asset acquisitions to expense immediately, substantial differences exist in the way physical assets are recorded in the public accounts of various jurisdictions. For example, differences occur in such areas as:

  (i) Reporting capital expenditures separately from operating expenditures; and

  (ii) As well as including the acquisition cost of physical assets, many jurisdictions include transfers, grants and debt servicing contributions for major public infrastructure in capital expenditures.

- Crown corporations, agencies and special funds in many jurisdictions hold government assets such as land, buildings and equipment. The accounting for these entities varies among jurisdictions as to their inclusion in, and basis of, accounting in consolidated financial statements. For example Saskatchewan's Property Management Corporation, which is responsible for all aspects of capital asset acquisition and management, is not part of the reporting entity in Saskatchewan's public accounts.

- Supplementary statements and schedules of capital outlay for physical assets vary significantly in content and detail among the jurisdictions.

3. Our analysis

Public Sector Accounting Statement 2 issued by PSAAC in November 1984 states that "reporting the difference between a government's financial assets and liabilities, alone, is not sufficient to provide users with an adequate description of a government's financial condition. ... It would therefore be beneficial to report information in financial statements about acquired physical resources which have a useful life extending beyond the accounting period."

In addition, the Auditor General has recently recommended that the government's financial statements disclose information to describe a government's physical assets on hand and available for use.

Reporting the physical assets on hand will provide the following benefits:

- Knowledge of the physical assets on hand will provide a basis to judge future maintenance and replacement costs.
- Information about physical assets provides the ability to determine what portion of government debt has been incurred for current operations as opposed to physical assets with future benefits.
- Financial statement readers will have an understanding that a portion of the current expenditures have probable future benefits for the province.
- Stewardship of physical assets should improve if physical assets are recorded in financial statements.
- Removal of the fiscal incentive to sell Crown assets when they have been recorded in the accounts at zero value.
- Accounting for and reporting of physical assets should provide information to help ensure a government's accountability for performance, including information useful for assessing matters of economy, efficiency and effectiveness.

On the other hand, there are some disadvantages:

- The costs of recording depreciation and continuing to track the asset base may exceed the benefits obtained, at least in the implementation phase.
- Although physical assets will initially be recorded at cost, inflation and difficulties in measuring depreciation could render the information less useful in future years.

4. Findings

A 1989 CICA research study, "Accounting and Reporting for Physical Assets by Governments", made a number of findings and conclusions:

- Physical assets should be reported in the statement of financial position and charged as an expense as consumed in use, as opposed to when they are acquired.

- The recorded value of physical assets should be written down to reflect any impairment of value that is expected to be permanent.

- Depreciable assets should be amortized in a systematic manner over their useful life.

- Natural resources should not be capitalized at this time. It indicates that this is an area for further research because of its "unique problems of definition, identification and valuation that must be researched before accounting and reporting policies could be recommended".

We believe that the government should be developing an approach which will move towards adoption of these findings.

5. Recommendations

In keeping with the recommendations of the CICA and the Auditor General, and the increasing recognition that public debt is represented by significant physical resources which are consumed over time, we believe that the province should consider the capitalization of assets. There is insufficient time to consider this for the 1992/93 Estimates but we believe it should be considered for implementation at the end of the 1992/93 fiscal year. We therefore recommend:

- The government should disclose proposed capital expenditures separately from operating expenditures in its annual Estimates. In addition, these expenditures should be distinguished in the Public Accounts, so that the amounts expended on physical assets are more visible.

- The government should move towards capitalizing physical assets, starting with those which can be readily identified and for which values can be ascertained. The primary group of assets to which this applies is buildings and, to a lesser extent, computer equipment and vehicles.

- An inventory of all other provincial physical assets should be prepared. For many assets, it will not be too difficult to determine historic cost but for others such as perhaps highways, bridges , other equipment, etc., within some ministries the task will be more difficult.

- There is currently no method for reporting approved financial plans for major capital projects nor subsequent follow up as to whether these plans have been achieved or not. Consequently, we recommend that a three year projection be provided for all approved major capital projects with information being provided in future years on the actual expenditures with explanations provided for significant variations from original plans.

- **Further study**

  - Since no other jurisdictions presently record natural resources as assets, further study is required in this area to determine whether an appropriate basis can be arrived at for recording these as physical assets. In the case of silviculture costs, an argument can be made for capitalizing certain of these costs (especially "not sufficiently restocked" or NSR related costs) but this needs to be studied further. A related issue is how annual change or depletion would be valued if these resources were recorded as assets.

  - While an inventory of physical assets is being prepared for the province, the cost and benefits of recording different types of assets on the statement of financial position should be determined.

The question of the appropriate accounting treatment for physical assets is of major significance and as described elsewhere, is interconnected with the subjects of fiscal agency loans and the reporting entity. Further study of these areas should be undertaken as a priority.

H. Contingent liabilities and commitments

1. Issues

The issues discussed below relate to the policies and procedures followed by the government for accounting and disclosure of contingent liabilities and commitments in the Public Accounts of the province. This issue is important to both the government and the users of the Public Accounts, as proper assessment and disclosure permits evaluation of the financial resources which will be required.

To the extent that the timing and amount of financial requirements arising from contingent liabilities and commitments can be identified at an early date, planning the activities of government is facilitated and revenue requirements can be identified early rather than in response to funding crises. Fiscal planning and responsibility is also improved by increasing the degree of accountability for current actions in relation to future consequences.

a. Contingent liabilities

For purposes of this discussion, a contingent liability is defined as an existing condition or situation which, upon the occurrence or non-occurrence of one or more future events, may give rise to a loss. Contingent liabilities involve those circumstances where the existence of a liability is itself uncertain, not merely where the amount of a known liability is uncertain.

Contingent liabilities include, but are not limited to, pending or threatened litigation, threat of expropriation of assets, guarantees of indebtedness of others and potential liability for environmental clean-up, site restoration and environmental degradation.

b. Commitments

Commitments, for purposes of this report, are contractual obligations or conditional liabilities to outside persons that become liabilities when the terms and conditions of existing contracts, agreements or legislation are met.

At present, the Consolidated Revenue Fund financial statements do not provide sufficient information to permit evaluation of the financial requirements arising from contingent liabilities and commitments and thus of government's ability to finance its activities and meet its liabilities and commitments. During our review, we noted that the government has significant contingent liabilities and commitments which are not disclosed in the notes to its financial statements. In addition, we believe that the government continues to treat matters as contingent liabilities long after the point at which it is likely that a real liability exists and the amount thereof can be reasonably estimated. This unduly defers the recognition of the related expense in the government's accounts.

In summary, the issues addressed in this report are in determining:

- the proper standard of disclosure for contingent liabilities
- the proper standard of disclosure for commitments
- the proper method of accounting for known liabilities for which the amount is uncertain

This report addresses these questions in relation to the objective of providing the user of the financial statements with the best possible information with which to evaluate the government's financial position and annual results.

2. Entities involved

Contingent liabilities and commitments may arise in any of the ministries of the government, Crown corporations and all other government entities. This paper focuses on the contingent liabilities and commitments of the Consolidated Revenue Fund.

a. Contingent liabilities

Pending litigation for which formal legal action has commenced is under the control of the Ministry of the Attorney General by virtue of the provisions of the Crown Proceeding Act, with the following exceptions:

- proceedings under the Income Tax Act
- proceedings under the Corporation Capital Tax Act
- proceedings under the Logging Tax Act and the Mining Tax Act
- assurance fund proceedings under Land Title legislation
- proceedings to which the Federal Courts Jurisdiction Act applies
- causes of action enforceable against corporations or other agencies which are owned or controlled by the Crown
- proceedings against the Crown for anything done in the due enforcement of the criminal law or penal provisions of an act
- proceedings under the Small Claim Act
- matters arising under the provisions of the Workers' Compensation Act

Liabilities arising out of matters which are subject to the Crown Proceeding Act are paid out of the Consolidated Revenue Fund. Amounts paid since 1985 pursuant to the provisions of the Crown Proceeding Act are reflected in the appropriations and expenditures of the Ministry of the Attorney General in the Public Accounts as follows:

	($ millions)	
1985/86	$1.0	
1986/87	2.8	
1987/88	1.1	
1988/89	1.1	
1989/90	22.8	
1990/91	1.6	
1991/92 (to December 31, 1991)	40.2	(including payments for the South Moresby account)

The budgetary estimate for payments pursuant to the *Crown Proceeding Act* was $1 million for 1990/91 and $950,000 for 1991/92. In 1989/90 and 1991/92, the amounts greatly exceed the estimated due to settlement of the significant cases in each of these years. Excluding these two settlements, the estimates have not been unreasonable.

Other identified sources of contingent liabilities include:

- claims against the Ministry of Transportation and Highways for compensation upon expropriation, and claims by construction contractors and designers
- claims against the Ministry of Finance and Corporate Relations relating to appeals under the Logging Tax Act, Mining Tax Act and Corporation Capital Tax Act
- claims on the Insurance and Risk Management Account (Ministry of Finance and Corporate Relations) relating to three self-insurance programs. Claims under two of these programs, the B.C. Health Care Risk Management Society and the Schools and Colleges program, could give rise to significant liabilities
- potential liabilities relating to environmental clean-up and site restoration
- threatened litigation in relation to which legal action has not yet commenced

A comprehensive review of all possible sources of contingent liabilities has not been carried out and therefore other significant sources of contingent liabilities may not have been identified. We have recommended that such a comprehensive review be undertaken.

b. Commitments

There are existing commitments in virtually all of the ministries of government. However, with the exception of commitments for capital projects, these are not disclosed in the financial statements. Of special interest is the degree to which Special Accounts represent commitments. For example, both the South Moresby Implementation Account and the Vancouver Island Natural Gas Pipeline Assistance Account reflect contractual obligations which will ultimately result in compensation or loans to third parties. Other accounts, such as the Lottery Fund, are created by Statute and the purposes for which the fund may be used therefore can be changed by statutory amendment. These type of accounts may have commitments to third parties where multi-year funding has been approved.

3. Government policies

a. Contingent liabilities

The Public Accounts for the year ended March 31, 1991 state that the accounting policy with respect to pending litigation is to indicate the amount of estimated or known claims in excess of $100,000 by note disclosure. No amount is accrued in the financial statements with respect to claims because the outcome of the litigation is uncertain.

The note to the financial statements also indicates that the government has contingent liabilities in the form of indemnities, indirect guarantees and outstanding claims which, except for indemnities for explicit quantifiable loans, are not recorded in the financial statements because amounts are uncertain.

The note to the 1990/91 financial statements also discloses a contractual obligation by the Province to clean up the Expo site of all hazardous materials. No potential quantum of this liability is disclosed.

b. Commitments

The notes to the 1990/91 financial statements include disclosure of total commitments for outstanding capital contracts and extraordinary programs. There is no disclosure of other types of commitments nor is there disclosure of when these commitments will need to be fulfilled. Other types of commitment which may be appropriately disclosed include commitments to make grants and loans and long-term contractual commitments to third parties.

The Financial Administration Act, states:

"25.(1) No agreement or undertaking of any kind providing for the payment of money by the government shall be entered into that would result in an expenditure in the then current fiscal year in excess of an appropriation for that fiscal year.

(2) It is a term of every agreement providing for the payment of money by the government that payment of money that becomes due under the agreement is subject to an appropriation being available for that agreement in the fiscal year when the payment falls due.

(3) The Treasury Board may by directive set conditions to be observed before agreements or undertakings providing for the payment of money by the government are entered into."

To ensure that the requirements of the Act are met, Section 27 states that:

"27. *Each minister shall establish and maintain, as directed by the Treasury Board, records of commitments chargeable to each appropriation of which he has charge."*

Subsection 8(2) of the Financial Administration Act requires that the financial statements of the government contain statements of obligations and commitments of the government. Financial Administration Operating Policy 9.2 provides direction in this regard and is discussed in the following section dealing with Government Practices.

In fact, compliance with subsection 25(2) of the Financial Administration Act is not feasible in all circumstances as economic and legal reality dictate that parties to agreements will act in reliance on the terms of the agreement. Given this circumstance, it is not a supportable argument that, by virtue of such provisions, the government has few, if any, commitments extending beyond the current year. It may be supportable that such provisions constitute a mitigating strategy on the part of the government.

4. Government practices

a. Contingent liabilities

The province's accounting policies do not deal with the recording of a liability for contingent losses but only report contingencies in a note to the financial statements. In certain circumstances, a liability may be recorded with respect to contingencies but we have been unable to identify a uniform practice across government which would define those circumstances. The one exception to this is in the treatment of probable losses on loan guarantees used by the government where it establishes a valuation allowance against these loan guarantees based on the loss experience of the guarantee program. This approach to recording expenditures for contingent losses is sensible and should be applied to all contingent losses.

In order to compile the note to the financial statements on contingencies, the Office of the Comptroller General requests annually that each ministry provide a listing of contingent liabilities with a potential liability of $100,000 or more. Ministries are asked to report only those matters which have not reached the litigation stage, which matters are reported on by the Ministry of the Attorney General. While the ministries, including the Ministry of the Attorney General, are asked to provide an evaluation of the expected result and estimated settlement, the gross amount of the claim is disclosed in the note to the financial statements.

For purposes of the Summary Financial Statements, amounts are disclosed with respect to Crown corporations and other government-owned agencies which are consolidated, but are not disclosed for those which are accounted for on the modified equity basis. However, the Public Accounts contain the

individual financial statements of most Crown corporations and agencies. These financial statements are intended to disclose all contingent liabilities.

Currently, a note to the financial statements discloses the following categories of contingent liabilities:

- pending litigation controlled by the Ministry of the Attorney General
- expropriations and construction claims by contractors and designers under the control of the Ministry of Transportation and Highways
- logging taxes, mining taxes and Corporation Capital Tax in dispute under the control of the Ministry of Finance
- a liability for clean-up of the Expo land site in an unknown amount
- disclosure that other types of contingent liabilities exist but are not evaluated

These disclosures are in addition to those related to guaranteed debt and unfunded pension liabilities.

Discussions with Office of the Comptroller General staff who collect and assemble information for this note indicate that they rely on information provided by the ministries without significant additional efforts to ascertain its completeness.

b. Commitments

Each Minister is responsible for establishing and maintaining records of commitments by virtue of the Financial Administration Act, section 27. Guidance on execution of this responsibility is provided by the Comptroller General under authority from Treasury Board in Financial Administration Operating Policy 9.2.

With respect to commitments expected to result in future years' expenditures, the policy states that these items are not current encumbrances but a first charge on future appropriations and that records are to be maintained with respect to such items. The policy also discusses the point of recognition of a commitment for purposes of entering it into the commitment control system.

At each fiscal year-end, the Office of the Comptroller General requests that each ministry provide it with totals for commitments in each of the two subsequent fiscal years in the following categories:

- collective agreements
- other operating contracts
- operating leases
- capital contracts
- contributions and grants

From these disclosures, the commitments indicated for capital contracts are aggregated and disclosed in the financial statements. In the 1990/91 Public Accounts, the total of $222 million reflected commitments greater than $100,000 under capital contracts as disclosed by the following Ministries:

- Crown Lands
- Energy, Mines and Petroleum Resources
- Environment
- Transportation and Highways
- Tourism
- Purchasing Commission

Significant commitments to make grants and contributions, loans or under operating leases are not disclosed.

c. Commitments and Special Accounts

Special Accounts form part of the Consolidated Revenue Fund and are not trust funds, as no assets are set aside separate and distinct from the assets of the General Fund.

Special Accounts are created by statute, but, in some cases, the provisions of the statute reflect the terms and conditions of underlying contractual obligations. Examples of Special Accounts which are reflective of contractual obligations are the Vancouver Island Gas Pipeline Assistance Account and the South Moresby Implementation Account. The majority of the Special Accounts reflect a political commitment to expend specified funds for specified purposes in future years. Some of the accounts may reflect a combination of contractual and legislative commitments.

For reporting purposes, revenues of a Special Account are recorded as revenues of the General Fund when received and expenditures are recorded when made; the appropriation for the amount does not, therefore, result in a recognized expenditure.

The Public Accounts include a summary of the operating statements of the Special Accounts and a summary of changes in the account balances, including disclosure of spending authority committed and spending authority available, or, for non-revolving accounts, uncommitted.

It should be noted that the Special Account balances represent commitments against the future revenues of the General Fund within the provisions of the underlying legislation and contractual agreements. This fact is not apparent from the audited financial statements for the General Fund but may be apparent from study of the unaudited supplementary schedules to the financial statements.

The South Moresby Implementation Account shows the potential effect of a Special Account. The Special Account is established pursuant to the provisions of the South Moresby Compensation Account Act and consists of two sub-accounts: The Forestry Compensation Account and the Forest Replacement Account.

The account includes amounts appropriated by the province and contributed by the federal government plus interest attributed to these amounts pursuant to the terms of an agreement between the federal and provincial governments for the establishment of a national park in the South Moresby area of the Queen Charlotte Islands.

Funds received from the federal government were recorded as revenue to the General Fund in the year of receipt and interest earned on the notional account balance, which includes the provincial appropriation, is similarly included in the General Fund when earned. Expenditures are recorded in the General Fund financial statements in the year made. The balance in the Forestry Compensation Account at March 31, 1991 was $37 million. Pursuant to the terms of settlement with one of the claimants for compensation and subject to approval by the federal government, substantially all of this balance will be expended in 1991/92 and this expended amount will constitute a current year expenditure of the General Fund. The current method of presentation of this account results in mismatching of the sources of funding and the expenditure. The revenues received from the federal government were, in essence, received as trust funds and if not used for the specified purpose, would have to be returned to the federal government. This commitment is not apparent from the financial statements and the funds themselves were included in the surplus or deficit amount in the year of receipt (1989/90). The provincial appropriation represents a commitment by the government to expend, but is not reflected as an expenditure until the qualifying payment is made.

Another instance of the potentially misleading nature of Special Accounts is the Vancouver Island Natural Gas Pipeline Assistance Account. Pursuant to the terms of an agreement between the federal and provincial governments and Pacific Coast Energy Corporation, the Province is obliged to provide $55 million of conversion grants to assist persons to convert to natural gas, up to $25 million in construction loans to the company, and an additional uncapped amount in loans to the company relating to a rate stabilization of natural gas.

The conversion grant and construction loan components of this agreement are reflected in the Vancouver Island Natural Gas Pipeline Assistance special account. The uncommitted balance at March 31, 1991 reflected the balance of the Province's commitment with respect to these two components. Funds to discharge these commitments must be generated from future borrowings or revenues.

The Rate Stabilization Facility Special Account was first recorded by a 1991/92 appropriation of $26 million. This balance will not be fully expended in 1991/92 and the Ministry of Energy, Mines & Petroleum Resources currently estimates total obligations over the next ten years at $186 million. This estimated commitment and the terms of the loan are not disclosed in the Public Accounts.

As a result of this lack of clarity, we recommend that the government critically evaluate Special Accounts with a view to minimizing them; the exceptions might be those Special Accounts which operate as Special Operating Agencies or Enterprise Centres. This recommendation is more fully considered in the issue paper on Financial Controls. In addition, the Public Accounts should disclose the nature, timing and amount of significant commitments. An indication of legislative versus contractual commitments would provide the user of financial statements with more information than is currently available to evaluate likelihood of fulfillment of the commitment.

5. Basis of assessment

a. Contingent liabilities

In order to assess the potential impact of contingent liabilities on the current deficit, we endeavoured to apply the standards set out in section 3290 of the CICA Handbook with respect to contingent liabilities. In the course of this review, we noted certain items which are properly characterized as liabilities with respect to which the amount of the liability is uncertain.

The degree of uncertainty relating to the occurrence or non-occurrence of the future event which will confirm or refute the existence of a liability is the major factor in determining the proper disclosure of a contingent liability pursuant to Section 3290 of the CICA Handbook. The disclosure requirements may be summarized in Exhibit IV.

Exhibit IV
Disclosure requirements

Probability of Occurrence or Confirmation of Liability	Amount of Loss can be Reasonably Estimated	Accounting Treatment and Disclosure
Likely—High	Yes	Accrue
Likely—High	No	Note Disclosure(but consider for accrual in portfolio assessments)
Not Determinable	Yes or No	Note Disclosure
Unlikely	Yes or No	No Disclosure Unless Possible Significant Adverse Effect

We believe that, for those circumstances where the probability of confirming the existence of a liability is high and the estimate of loss indicated is a range of amounts with no particular amount within the range being a better estimate than any other, the amount at the lower end of the range should be accrued.

We also believe that given the trend of increasing litigation, particularly tort litigation, against the government, and the lengthy period between the time when the incident giving rise to a potential liability occurs and Crown liability is ascertained, it is more informative to reflect any likely liability by an accrual as soon as it can be identified and a reasonable estimate of the loss determined. Moreover, as described earlier, with possible losses on loan guarantees, it is important to assess such matters on a portfolio as well as on an individual basis.

b. Commitments

We have not endeavoured to establish the total quantum and timing of various types of commitments. We are, however, of the view that material commitments of government should be reflected by way of note to the financial statements.

I. Basis of analysis

In order to reflect the proposed accounting policy with respect to contingent liabilities, we carried out the following procedures:

1. Ministry of Attorney General—Pending litigation

We requested that the Ministry of the Attorney General apply the standards set out in section 3290 of the CICA Handbook at to the pending litigation which may give rise to a loss in excess of $100,000. For this purpose, likely liability was defined as a 70% chance that the Crown will be found liable or partially liable with respect to a particular action. For those cases which, in the opinion of the litigator, there will likely be a future event confirming liability, we requested a best estimate of the potential liability where such amount is determinable at January 1992. This evaluation was requested both at March 31, 1991 and December 31, 1991.

Our review of the information provided was limited but our discussions with staff responsible for obtaining the information required indicated an excellent understanding of the requirements.

2. Ministry of Transportation and Highways

We requested updated lists of expropriation claims and evaluation of the likely quantum required to settle the claim. It should be noted that very few of these claims involve a denial of liability and therefore the estimated cost of resolution of these claims should be accrued in the financial statements as an estimated liability rather than reflected as a contingent liability.

We noted in the course of this review that the Ministry of Transportation and Highways does, in fact, record amounts as accrued liabilities when the amount of expected settlement is virtually known but no amount is recorded if there is a range of settlement estimates. This practice has resulted in double counting certain amounts as both accrued liabilities and contingent liabilities.

The Ministry also has construction claims from contractors. We requested an updated list of the claims and the expected result. Again, there are virtually no claims for which the Ministry completely denies liability.

The Ministry has estimated the amount of the possible accrual for these expropriation and design claims within very broad parameters and we have not engaged in any case by case review of the evaluations.

3. Risk Management Branch—Ministry of Finance and Corporate Relations

This branch operates two significant self-insurance programs—the B.C. Health Care Risk Management Society plan and the Schools and Colleges plan. There are several hundred claims outstanding which may reflect liabilities against these plans.

For purposes of the Public Accounts, these plans and other plans operated by the Risk Management Branch are reflected in a Special Account of the Ministry of Finance and Corporate Relations called the Insurance and Risk Management

Account. The expenditure recorded each year in the General Fund is the actual amount of claims paid and other expenses of the Branch.

The Risk Management Branch estimates reserves required to satisfy outstanding claims on an ongoing basis with a special in-depth review taking place twice each year. The reserves are based on the estimated percentage liability multiplied by the estimated damages plus costs based on best information at the time of evaluation.

This method of determining an accrual for accounting purposes is, in our view, in accordance with the CICA Handbook recommendation as it provides a reasonable estimate of the likely liability of the Crown.

4. Ministry of Finance and Corporate Relations

Included in the contingencies note to the financial statements at March 31, 1991 was $7 million relating to pending litigation contesting assessments for logging taxes and mining taxes. The Ministry evaluation of outcomes with respect to these claims indicate an anticipated liability of 50% in virtually every case.

Strictly speaking, this assessment would not indicate any accrual of liability in respect of these amounts, nor is the evaluation entirely reasonable.

However, as we have not conducted a case by case review of the issues involved, we have included no amount in our accrual adjustment for these items.

5. Contingent liabilities in relation to environmental clean-up and degradation

The government does not have a comprehensive accounting policy for recognition of potential liability for environmental matters.

Government liability for environmental matters may arise in two contexts: as the owner or occupier of the source of the contaminant or as the body which had the responsibility for management or control of the contaminant either directly or within the context of the regulatory scheme.

Environmental matters may require disclosure and measurement in the financial statements of the government arising from:

- Claims threatened or pending or probable assertion of a claim.
- Clean-up costs and future removal and site restoration costs.

Section 3060.39 of the CICA Handbook dealing with Capital Assets recommends accrual of future removal and site restoration costs, net of expected recoveries, in relation to such capital (physical) assets. Such accruals would be made when the likelihood of their incurrence is established as a result of:

- Environmental law.
- Contract.
- When a policy has been established to restore a site, and where the costs can be reasonably determined.

Such provisions would be recorded as an expenditure and accrued as a liability and therefore, such an accounting policy would not be dependent on the policy adopted for recording physical assets.

If the amount of the liability cannot be reasonably estimated, such as in circumstances where the environmental assessment has not yet taken place, the Handbook suggests that a contingent liability may exist which would be subject to the disclosure requirements outlined previously.

In our view, this policy is appropriate for government as it provides the reader of financial statements with information regarding the actual liability for such costs. The issue paper on Environmental Cost Issues has provisionally estimated unrecoverable environmental clean-up costs over the next several years to be in the range of $65 to $180 million. The liability should be recorded where reasonable estimates are determined. This would be the circumstance in virtually all of the cases where the liability arises by virtue of contractual obligation or a policy decision to restore a site is made.

J. Findings

1. The Ministry of the Attorney General—Pending litigation

The Ministry of the Attorney General reports in excess of $830 million of outstanding legal claims in respect of suits where damages on an individual case basis may be in excess of $100,000 at January 10, 1991.

The litigators responsible for the open case files have evaluated the claims in light of the CICA Handbook requirements with respect to contingencies both at March 31, 1991 and at January 10, 1992.

For purposes of determining the amount of the contingent liability with respect to pending litigation which should be accrued in accordance with the provisions of the CICA Handbook, the following rules were followed by the Ministry staff:

a. Outcome was defined as a 70% probability that the litigation would result in Crown liability.

b. If liability was considered to be likely, an estimated quantum of damages was indicated where such an amount was determinable based on information known to date.

c. If a range of possible damages was estimated and no amount within the range was considered better than any other amount, the lower end of the range was selected as the estimated quantum damages.

d. The assessment was carried out as at March 31, 1991 and as at January 10, 1992.

The estimated accruals at the specified dates determined as indicated above are:

	($ Millions)
March 31, 1991	$ 13.2
Less:	
Over accrual at March 31, 1991 based on currently available information	(2.5)
Add:	
Increased estimates to January 10, 1992 based on current assessment	19.6
Estimated cumulative accrual at January 10, 1992	$ 30.3

There is therefore an estimated effect on the accumulated deficiency at March 31, 1991 of $13.2 million and on the current year's deficit of $17.1 million.

It should be noted that this accrual does not reflect the estimated probable Crown liability with respect to litigation pending since there are a large number of cases with a slight or indeterminable probability of liability or an indeterminable potential liability amount.

Of the claims totalling in excess of $830 million, the estimated accrual at January 10, 1992 of $30.3 million relates to anticipated claims totalling $151.2 million. Two cases have been identified as constituting a likely liability, but no estimate of damages is reasonably determinable at this time.

2. Ministry of Transportation and Highways

The Ministry of Transportation and Highways provided us with lists of pending litigation which was not referred to the Ministry of the Attorney General at March 31, 1991 and December 31, 1991. These lists are mainly for expropriation claims and contractors' construction claims and provide the estimated quantum of the claim and estimated settlement.

As indicated in this report, the great majority of the cases are matters for which the Crown is liable but for which the amount of the liability is uncertain. These are liabilities, not contingent liabilities.

Using the Ministry's estimates of anticipated damages as an estimate of the amount which would be accrued if CICA Handbook recommendations had been applied, an approximate estimate of the accrual at March 31, 1991 and December 31, 1991 is as follows:

	($ millions)	
	Total Amount of Claim	Estimated Settlement
March 31, 1991	$39.2	$10.4
Less Accrual Recorded		$4.6
Additional Accrual required at March 31, 1991		$5.8
December 31, 1991 (estimate)	$63.0	$14.0
Less Proposed Accrual to March 31, 1991		$10.4
Proposed Additional Accrual at December 31, 1991		$3.6

There is therefore an estimated effect on the accumulated deficiency at March 31, 1991 of $5.8 million and on the current year's deficit of $3.6 million.

These estimates have not been reviewed by us in any further detail and, particularly, not in conjunction with the relevant files; and they likely provide a low estimate of the probable liability.

3. Risk Management Branch—B.C. Health Care and schools and colleges self-insurance funds

These self-insurance plans are included in the Insurance and Risk Management Special Account. For financial reporting purposes, the amount expended from the account each year is reflected as an expenditure of the General Fund. No accrual is made for claims pending against the self-insurance plans nor is any contingent liability reflected by note with respect to the plans. By virtue of the Financial Administration Act, the account balance is available to discharge the future claims and the account balance may be a deficit. However, since there are no funds on deposit available to discharge the contingent liabilities of the account, these liabilities must be paid from future years' revenues.

As both of these plans were instituted approximately five years ago, expenditures are rising as the plans mature. The Risk Management Branch calculates reserves with respect to outstanding claims as discussed earlier in this report; however, these reserves are not reflected in the Public Accounts.

We have used the reserves calculated by Risk Management Branch as an estimate of the contingent liability to be accrued pursuant to the recommendations of the CICA Handbook with respect to contingencies.

The reserves at the following dates were approximately as follows:

	($ Millions)		
	Health Care Plan	Schools and Colleges Plan	Total
March 31, 1991	$9.8	$4.4	$14.2
November 30, 1991	11.0	5.1	16.1
Change in Accrual from March 31, 1991 to November 30, 1991	$1.2	$0.7	$1.9

4. Ministry of Finance tax appeals

As at March 31, 1991, the Ministry of Finance reported $8.2 million of pending litigation to the Office of the Comptroller General relating to Logging Tax and Mining Tax appeals and other tax appeals. $7 Million of these appeals were reported as contingent liabilities in the note to the 1990/91 General Fund financial statements.

The Ministry reported an expected result of 50% settlement on virtually all of the matters listed and therefore reported an estimated settlement of approximately 50% of the amounts under appeal.

We have not determined the comparable amounts at December 31, 1991, nor have we reviewed the estimates at March 31, 1991.

Given the relatively small magnitude of the amounts and the suspect evaluation in relation to probable outcome, we recommend further review with respect to these items and have reflected no suggested accrual in respect of them.

5. Expo lands and other clean-up costs

The 1990/91 Public Accounts include a note to the financial statements that the Province is contingently liable for clean-up of the Expo lands site pursuant to the terms of the sale agreement.

Current estimates relating to the cost of this clean-up are between $50 million and $100 million. We understand that this best estimate has not changed since March 1991. It is further our understanding that $17.5 million has been spent to date with respect to clean-up of hazardous materials from the site.

Based on the confirmed existence of this liability, we recommend that the Public Accounts reflect an accrual of $50 million at March 31, 1991. Overall, we have therefore recommended that the Public Accounts reflect an accrued liability of $68 million at March 31, 1992.

6. Criminal Injuries Compensation

Appropriations pursuant to the Criminal Injuries Compensation Act are included in the total appropriations for the former Ministry of the Solicitor General, now the Ministry of the Attorney General. The program is administered by the Workers' Compensation Board and is for the purpose of compensating victims of crime.

There are currently approximately 8,000 open claims under this program. These open claims include applications for compensation awaiting adjudication and claims which are subject to ongoing obligations by the Crown and therefore represent both liabilities and contingent liabilities of the Crown.

This program represents a reasonable significant commitment of government. The 1990/91 appropriation was $4.6 million but no amount was included in the original estimates.

No estimates are currently available of the total liability for awards to date or the estimated contingent liability with respect to claims pending.

We recommend that the existing obligations be assessed and an evaluation completed of the files pending in order to reflect an estimate of liability and likely liability in the Public Accounts.

The growth in awards paid due to recent increases in program limits and parameters of expanding legal liability. In our opinion, the existing liability and likely contingent liability in respect of these claims should be ascertained and reflected in the Public Accounts as an accrued liability. It is likely that a review of the claims would indicate that an accrual would reasonably be estimated at a fixed dollar amount per file or per file of a particular type.

7. Indemnities

We note that the Province has a large number of outstanding indemnities, many of them unlimited.

We recommend that these indemnities be subject to a risk control and evaluation procedure to facilitate early identification of likely liabilities and estimates of quantum. These indemnities should be subject to the same disclosure requirements as other contingent and actual liabilities, including accrual of those evaluated as

likely to give rise to a liability where the amount of the liability may be reasonably estimated.

8. Other contingencies

We have identified other possible contingent liabilities and actual liabilities in the following areas:

- Environmental clean-up costs.
- Rectification of or potential liability for environmental degradation.
- Potential building and site clean-up costs.
- Potential law suits for expropriation in acts tantamount to expropriation.
- Potential contingencies relating to the operation of certain Special Accounts.
- Asset values impaired by the existence of noxious or unsafe conditions.

We believe that further study would reveal additional contingent liabilities and that complete evaluation of the known and unknown contingent liabilities would disclose significantly greater unrecorded liabilities and contingent liabilities than are indicated herein.

K. Conclusions and recommendations

We recommend changes to existing accounting policy which we believe will enhance attainment of the following objectives:

- Accountability for current actions which give rise to future consequences.
- Early identification of future funding requirements.
- Provision of information to users of financial statements which facilitates evaluation of the government's current position and ability to finance its future activities.

Specifically, we recommend the following changes to existing accounting policy and practice:

1. Liabilities

Actual liabilities are currently recorded to the extent they represent claims payable to outside parties (including probable losses on loan guarantees) as a result of

events and transactions prior to the year-end. There may be some items currently considered contingent liabilities which fit this category. They should be reviewed and accrued in the Public Accounts when a liability exists and its amount may be reasonably estimated.

2. Contingent liabilities

Contingent liabilities should be accrued in the financial statements when it is likely a liability exists and the amount of the liability can be reasonably determined. This includes assessing items on a portfolio as well as on an individual basis. This is consistent with a definition proposed by the Auditor General who suggested that such contingent liabilities should be carried "where there is a clear, legal obligation to incur expenditures ... and the amount of the obligation can be reasonably estimated".

3. Commitments

Commitment disclosure in the financial statements should be significantly expanded to include all material commitments. The disclosure should include information which permits the financial statement reader to assess the risk associated with the commitment such as whether the commitment arises by virtue of statute, is contractual or is a consequence of a policy decision.

The note should also disclose the timing and estimated amount of the commitment.

4. Indemnities

Indemnities outstanding should be subject to risk evaluation on a periodic basis to determine the existence of any liabilities or likely liabilities at an early date.

5. Special Accounts

As described in the issue paper on Financial Controls, the use of Special Accounts should be critically evaluated and those no longer deemed necessary discontinued. These accounts and their presentation currently provide potentially misleading information to the user of financial statements, and some result in improper matching of revenues and expenditures and imply the existence of trust funds. Further, it is not clear that the fund balances represent contractual or legislative commitments which must be funded from future revenues. Where appropriate, there should be expanded commitment disclosure to identify the nature of the various commitments to which they relate.

6. Implementation

In our view, the initial implementation of the foregoing policies would necessitate significant effort on the part of government to define the parameters for the additional disclosure and effectively communicate them across government. In

addition, the fact gathering and evaluation process is likely to be time-consuming in the short term.

This initial process should be undertaken at the earliest possible date in order to reflect any cumulative adjustments as a prior period adjustment in the financial statements for the current year.

Once the requirements have been effectively communicated and the necessary processes implemented for the ongoing risk evaluation process necessary to implement these recommendations, the ongoing process should not be unduly onerous. It may be feasible for certain types of liabilities and contingent liabilities to generate realistic global provisions and thereby mitigate the need for ongoing detailed evaluation. The extent to which this approach would prove useful is dependent on the types of undisclosed liabilities and contingent liabilities found which have not been identified in this report.

In determining the appropriate disclosures with respect to contingent liabilities and certain commitments, the government should be mindful of the need to avoid disclosures which could prejudice the outcome or determination of the existence of a liability. This risk arises particularly in the context of disclosure of lawyer-client privilege and in the potential for an adverse party to assert that evaluation of potential liability is an admission. Advice of the Attorney General should therefore be sought in the policy formulation stage.

L. Overall effect of accounting policy recommendations

In this review we have examined the government's accounting policies and found that, in many respects, they satisfied the requirements of PSAAC and are providing as much, and in some cases more, disclosure than other government jurisdictions. However, we also found significant room for improvement and have made a number of recommendations which, if implemented, will ensure the government satisfies the concerns of the Auditor General and the recommendations made by PSAAC. We have also made, in a few cases, recommendations which are ahead of PSAAC and, if implemented, will place British Columbia close to the forefront of public sector accounting and disclosure. We believe that such reporting is important for providing a full and complete accounting of the financial affairs of the government and the organizations which it owns or controls.

Of particular importance in this area is the question of physical assets. The government allocates a significant amount of its financial resources to the acquisition, operation, maintenance and replacement of physical assets. A major part of the public debt is represented by physical assets which are consumed over time. In our view, it is inappropriate for the government to report simply its total liabilities and financial assets. A significant portion of the cost of physical assets should also be reported to demonstrate to the taxpayer that debt is represented by

physical assets which, although requiring ongoing maintenance, will produce services and thus reduce future demand upon financial resources.

An important effect of non-recognition of physical assets has been shown in this Financial Review by the recent increase in social capital. The deferral of spending on physical assets in the social area (schools, hospitals, universities, etc.) in the mid-1980s has placed an unexpected demand for new physical assets over the next few years. Current accounting policy would preclude the future benefit of these assets from being reported as physical assets which could potentially produce services and thus reduce future demands on public debt. We hope the government will study this issue as a matter of priority and that PSAAC recognizes the importance of dealing appropriately with physical assets.

Our recommendations, as described, fall into two categories: those where we have recommended immediate acceptance and those where we have suggested further study but which, if our recommendations are accepted after this further study, should be implemented as soon as possible.

For those where we have recommended immediate acceptance, we have also recommended retroactive adjustment. This would apply to our recommendations on unfunded pension obligations, government transfers, contingent liabilities, and concessionary loans. We recognize that it is relatively unusual for government to restate the accounts for prior years. Indeed, in most cases we believe that such retroactive restatement should not be applied, especially where controversial government transactions are concerned. We also recognize that accounting standards for government are evolving and that, as a result, there may well be a number of accounting policies changed in future years. However, the policy changes we have recommended are fundamental to the government's definition of liabilities and financial assets. As a result, we believe it is more appropriate to apply this method of accounting for these policy changes. PSAAC also concurs and, at least for the most significant recommended change, unrecorded pension liabilities, it has recommended retroactive restatement. The effect of making the adjustments in this way are noted in Exhibit V.

We have not quantified the effect of those other proposed changes where we have recommended further study. The implications of the recommendations on these items will only become fully evident when that study is complete.

Overall, we are satisfied that, in complying with all of these recommended changes in accounting policy, the government will have responsibly discharged its objective for providing full and complete disclosure to the readers of its financial statements.

Exhibit V
Summary of adjustments resulting from proposed accounting policy changes

	Years Prior to March 31, 1991	1991/92	March 31, 1992
IMMEDIATE ADJUSTMENT:	(Deficit Increase $ Millions)		
1. **Pension Funds**			
•Unfunded liability			
-Public Service Superannuation, etc.	445	68	513
•Unfunded liability			
-Disability Fund	34	2	36
•Unfunded liability			
-Enhanced pensions(Judges, Deputies, etc.)	8	1	9
2. **Concessionary Loans**			
•Write-down in values	79	11	90
•Student Loan Remission Program	30	10	40
3. **Government Transfers**			
•Earlier recognition of grants			
-Lottery Funds	65	5	70
4. **Contingent Liabilities**			
•Pending Litigation— Ministries of Attorney General and Transportation and Highways	19	21	40
•Risk Management—Self-Insurance	14	2	16
•Environmental Clean-Up	50	18	68
INCREASE IN CUMULATIVE NET DEFICIENCY	$744	$138	$882
DEFER ADJUSTMENT:			
5. **Reporting Entity**			
•Unremitted equity in Crown corporations			
•Reduction in net assets resulting from consolidation and modified equity			
•Adjustments to investments (e.g., B.C. Rail and PNE)			
6. **Fiscal Agency Loans**			
•Financing Authorities			
•Others (B.C. Transit, etc.)			
7. **Physical Assets**			
•Buildings and equipment			
•Other assets			